Economics and Sociology
Occasional Paper No. 2398

THE NEW DEVELOPMENT FINANCE

by

Claudio Gonzalez-Vega

October 1997

Rural Finance Program
Department of Agricultural Economics
The Ohio State University
2120 Fyffe Road
Columbus, Ohio 43210-1099

Abstract

This short paper looks at general questions about the role of finance in economic development and about the role of the state in financial development from the perspective of the New Development Finance. It addresses the contributions of new theoretical developments and of best practice in microfinance to the expansion of the frontier in the provision of financial services to poor people. A research agenda for the future is proposed.

THE NEW DEVELOPMENT FINANCE

by

Claudio Gonzalez-Vega[1]

The Rural Finance Program at The Ohio State University is very pleased to co-sponsor this First Annual Seminar on the New Development Finance.

Why a seminar on Development Finance at this time? Among the most intense, long-standing, and unresolved debates in Economics are debates concerning:

(a) the role of finance in economic development, and
(b) the role of the state in financial development (Stiglitz, 1993).

After being somewhat dormant, in recent years these debates have been renewed with particular intensity. This renewed interest has reflected, on the one hand, important theoretical developments and, on the other hand, new calls for the deployment of finance to address politically-important problems and politically-correct issues (Gonzalez-Vega, 1994).

I will not spend much time reviewing the recent theoretical literature on the role of finance in economic growth and development (see King and Levin, 1993a and 1993b; Pagano, 1993; Gertler and Rose, 1994; Gonzalez-Vega, 1996; and Winkler, 1997).

In the mid-1970s, Edward S. Shaw (1973) and Ronald I. McKinnon (1973) at Stanford University had challenged earlier models of growth that either ignored finance or had incorporated finance in ways that made it impossible to recognize and correctly appreciate the contributions of finance to economic development. Because policies based on those earlier (mostly Keynesian) models had led to financial repression, the potential contributions of financial development to economic growth had not materialized.

In contrast with earlier economic theory, both Shaw and McKinnon incorporated money and finance into models of growth relevant for the developing countries and strongly influenced the financial policy reforms of the following two decades (McKinnon, 1988). After their graduate

[1] Opening remarks at the First Annual Seminar on the New Development Finance, held in Frankfurt on September 22 - October 2, 1997, sponsored by the Goethe University of Frankfurt, the Rural Finance Program at The Ohio State University, Internationale Projekt Consult, Bannock Consulting, and Development Alternatives, Inc. Gonzalez-Vega is Professor of Agricultural Economics and of Economics and Director of the Rural Finance Program at The Ohio State University. The style of the oral presentation is preserved.

students and a few others exhausted the theoretical implications of the insights of the pioneers, however, little else happened for quite a while in the theoretical literature on growth and finance (Gonzalez-Vega, 1976; Galbis, 1977; Mathieson, 1980; Fry 1982; Kapur, 1983; Van Winjbergen, 1983).

This situation has changed rapidly in recent years, with the proliferation of the new models of endogenous growth, as the new Macroeconomics literature once again has focused its attention on the performance of economies in the long-run (Romer, 1986; Lucas, 1988). In these new models, financial development has emerged as one of the key determinants of long-term economic growth (Greenwood and Jovanovic, 1990; Bencivenga and Smith, 1991; Levine, 1991; and Saint-Paul, 1992, among others).

Moreover, despite considerable debate about data, methodologies, and the actual direction of causality, the empirical evidence, recently systematized, strongly supports the view that financial development is an important determinant of economic growth. Among many others, Gelb (1989), King and Levine (1993a), and Levine and Zervos (1996) have shown that indicators of financial deepening have a strong, positive correlation with rates of economic growth, the accumulation of (physical) capital, and the efficiency of capital.

At the Microeconomics level, an equivalent question about which less consensus exists but that has experienced a similarly intense analysis, is the extent to which access to financial services influences the incomes and, more generally, the economic welfare of specific economic agents and, in particular, the poor (Besley, 1995). The question of the impact of finance on incomes, poverty levels, and the quality of life of different sectors of the population will be addressed later on during this Seminar (see Hulme and Hosley, 1996). Tomorrow I will discuss, from the perspective of what the donors can and cannot do, should and should not do, ways in which finance contributes to making the life of the poor somewhat better.

Moving on to the second debate, the views about the role of the state in financial development and, in consequence, the views about the role of donors, since these are simply an extension of the public sector, are more divergent and are more passionately held than the views on the role of finance in economic development. The views and perspectives about the role of the state matter a lot, moreover, because they influence actual policies and programs and, in the end, social welfare.

That these views diverge so much in the area of finance reflects both strong value judgements and the complexity of finance itself. Financial development is indeed a particularly complex and difficult process:

(1) Financial contracts cannot be easily summarized in terms of a price and the quantity of some homogeneous commodity; rather, financial transactions are characterized by a multitude of complex and heterogeneous contract terms and conditions. This complexity emerges from the inter-temporal, contingent, and non-homogeneous features of financial contracts.

(2) Moreover, due to a number of obstacles and breakdowns, the emergence of financial markets usually encounters formidable difficulties, and interest-rate adjustments do not necessarily equilibrate supply and demand. These breakdowns include instances of market failure (market power, externalities and public goods, adverse selection and moral hazard), policy and government failure (rent-seeking, agency costs), incomplete organizational infrastructures (property rights, contract enforcement), free-riding and failure of collective action, as well as the unsustainable property rights and governance structures of development finance organizations introduced exogenously (Besley, 1994; Gonzalez-Vega, 1997a). Additional obstacles to financial transactions reflect wealth constraints and covariance risk (Rosenzweig and Wolpin, 1993; Binswanger and Deininger, 1995).

As a result of these complexities, obstacles, and breakdowns, the promotion of financial deepening (when and how?) is a difficult task for policymakers everywhere. It is not surprising, therefore, that in practice government intervention in financial markets has produced at best mixed outcomes and most of the time disappointing results.

Moreover, financial deepening does not take place at a uniform pace. Market and non-market financial institutions and different types of financial services, assets, and liabilities emerge only gradually during processes of economic growth and development (Gurley and Shaw, 1967; Goldsmith, 1969). At different stages in the process of economic development, different constraints on the demand and the supply of financial services limit the range of products that are available and delay the advent of new organizational forms. Moneylenders and ROSCAs emerge centuries before stock exchanges and derivatives. Thus, some types of services, instruments, and organizations appear early, while others lag behind.

Separating what exists and what does not exist and what is feasible and what is not feasible at a given stage of development is the *frontier* (Von Pischke, 1991). Economic opportunities for the emergence and introduction of new types of financial organizations and products appear when incomes increase, market size grows, and opportunities for taking advantage of economies of scale and economies of scope appear.

When improvements in information flows and in mechanisms for contract enforcement take place, when the evolution of financial technologies reduces transaction costs for all market participants and/or when better mechanisms for the management of risk attract new actors to financial markets, the frontier expands. In general, high costs and high risks for market participants typically explain the difficulties of introducing new types of financial services. When these obstacles are overcome, transaction costs decline, and new types of financial services can be provided on a profitable and sustainable basis.

The frontier expands, but the frontier never expands at a uniform pace. It is softer and easier to push at some locations; it is stubbornly resistant to expansion at other locations. We know about some of these difficult locations: long-term contracts, risk capital to start up new firms, financial services for the poor. They are like stations in the *via cruxis* towards financial heaven.

Development finance is about pushing the frontier outwards at difficult locations.

The political authorities become especially interested in development finance when opportunities to expand the frontier for politically-important constituencies appear. In recent years, much hope has been spurred that poverty could be alleviated in developing countries by expanding the microfinance region of the frontier (Gonzalez-Vega, 1997b).

Thus, development finance has become important again, in search of answers to the politically-charged call that finance be deployed to combat poverty (Microcredit Summit, 1997). These calls have been accompanied by demands that governments and donors design and implement new policies and programs to promote the expansion in the provision of financial services to the poor. This Seminar attempts to evaluate appropriate and successful and inappropriate and unsuccessful ways to answer this call.

For the Rural Finance Program at The Ohio State University, the nature of this challenge is not new. In the 1950s and 1960s, similar political urgency accompanied calls to use development finance to expand the frontier in the neighboring region of small farmer credit. The failure of the inappropriate responses to that earlier call, well-documented by Ohio State researchers, not only increases the political urgency that development finance do a better job this time around, but it also forces us, researchers, donors, and practitioners, to approach the new challenge in a cautious and humble way (Adams and Von Pischke, 1992).

Three sets of circumstances are new since the time of the small farmer credit programs of earlier decades. These circumstances offer promising opportunities to avoid the mistakes of the past. First, the causes and widespread costs of earlier policy failures are well understood and documented (Adams, Von Pischke, and Graham, 1984; Von Pischke, 1997). There is close to a professional consensus that those mistakes should not be repeated. These well-known lessons were the main contribution of the Rural Finance Program at Ohio State in the 1970s and 1980s.

Second, elegant recent economic theory has identified and explained the problems of information, incentives, and contract enforcement that make the emergence of financial transactions and financial markets so difficult and costly (Hoff and Stiglitz, 1993). This new economic theory has allowed a better understanding of the nature of the obstacles and breakdowns that must be overcome for the frontier to expand. We now have a better diagnosis of the financial markets problem.

Third, in a few places, effective combinations of financial policies, lending technologies, and organizational designs have allowed substantial gains in the outreach and sustainability of microfinance (Rhyne and Otero, 1994; Christen *et al.*, 1995; Chaves and Gonzalez-Vega, 1996; Gonzalez-Vega *et al.*, 1997). The frontier is expanding in places where a few decades ago it was widely believed to be impossible (Morduch, 1997).

There is an important distinction, however, between the second and the third of the new developments. The theoretical literature has been primarily concerned with instances of market failure that result from imperfect and asymmetric information and to some extent with problems resulting from limited mechanisms for contract enforcement. Taking these problems as given, the theoretical literature usually examines alternative forms of (optimum) intervention and their impact on Pareto efficiency (Rashid and Townsend, 1992).

At Ohio State we tend to believe, however, that what may appear to be a theoretically beneficial government intervention can easily go wrong in practice. Moreover, the covariance, asymmetric information, moral hazard and incentive problems that lead to market failure in the first place cannot be overcome directly with a public-policy intervention, however well-intentioned and well-designed. Governments face the same covariance, information, and incentive problems as private lenders, in addition to facing other (agency and political economy) difficulties of their own.

In contrast, best practice in microfinance does not take these information and contract enforcement constraints as given (Gonzalez-Vega, 1997a). Instead, best practice in microfinance emphasizes and actually undertakes financial innovation to address these constraints and overcome them.

I believe that the most important research agenda for the New Development Finance is to understand better:

(a) the circumstances under which innovations in financial technologies occur (including the externalities in knowledge generation and other problems that delay their emergence),
(b) key components of these financial innovations that can be replicated in attempts to overcome information and contract enforcement obstacles in different environments, and
(c) types of organizations (property rights and governance structures) that are more likely to adopt the financial innovations in a sustainable fashion.

This Seminar on the New Development Finance brings together academics with the innovators and the practitioners of the new microfinance technologies. There is a lot that the academics can learn from the practitioners. Moreover, hopefully the policymakers at the Seminar will recognize that, although academics and practitioners talk in different jargons, academics and practitioners are increasingly speaking the same language: sustainability and institution building matter! (Schmidt and Zeitinger, 1994).

Once again, researchers at the University of Frankfurt and at The Ohio State University converge conceptually. We are particularly grateful that the University of Frankfurt accepted the asymmetrical task of taking care of all of the logistical arrangements for the Seminar. We look forward to an exciting two weeks, and to many repetitions of the Seminar in the future.

References

Adams, Dale W and J.D. Von Pischke (1992), "Microenterprise Credit Programs: Deja Vu," *World Development*, No. 10 (October), pp. 1463-1470.

Adams, Dale W, J.D. Von Pischke, and Douglas H. Graham, eds. (1984), *Undermining Rural Development with Cheap Credit*, Boulder, Colorado: Westview Press.

Bencivenga, V.R. and B.D. Smith (1991), "Financial Intermediation and Endogenous Growth," *Review of Economic Studies*, Vol. 58, pp. 195-209.

Besley, Timothy (1994), "How Do Market Failures Justify Intervention in Rural Credit Markets?," *The World Bank Research Observer*, Vol. 9, No. 1, January.

Besley, Timothy (1995), "Savings, Credit and Insurance," in Jere Behrman and T.N. Srinivasan (eds.) Handbook of Development Economics, Vol. 3A, Amsterdam: North Holland.

Binswanger, Hans P. and Klaus Deininger (1995), "Towards a Political Economy of Agriculture and Agrarian Relations," unpublished paper, Washington, D.C.: The World Bank.

Chaves, Rodrigo A., and Claudio Gonzalez-Vega (1996), "The Design of Successful Rural Financial Intermediaries: Evidence from Indonesia," *World Development*, Vol. 24, No. 1, pp. 65-78.

Christen, Robert Peck, Elisabeth Rhyne, Robert C. Vogel and Cressida McKean (1995), "Maximizing the Outreach of Microenterprise Finance: An Analysis of Successful Microfinance Program," USAID Program and Operations Assessment Report No. 10, Washington, D.C.: Agency for International Development.

Fry, Maxwell J. (1982), "Models of Financially Repressed Developing Economies," *World Development*, X, September.

Galbis, Vicente (1977), "Financial Intermediation and Economic Growth in Less Developed Countries: A Theoretical Approach," *Journal of Development Studies*, January.

Gelb, Allan (1989), "Financial Policies, Growth, and Efficiency," Working Paper No. 421, Washington, D.C.: The World Bank.

Gertler, Mark, and Andrew Rose (1994), "Finance, Public Policy, and Growth," in Gerard Caprio, Jr., Izak Atiyas, and James A. Hanson (eds.), *Financial Report. Theory and Experience*, Cambridge: Cambridge University Press.

Goldsmith, Raymond W. (1969), *Financial Structure and Development*, New Haven: Yale University Press.

Gonzalez-Vega, Claudio (1976), "Economic Growth and Financial Intermediation: Comment," Ronald I. McKinnon (ed.) *Money and Finance in Economic Growht and Development*, New York: Marcel Dekker.

Gonzalez-Vega, Claudio (1994), "Stages in the Evolution of Thought on Rural Finance: A Vision from The Ohio State University," Economics and Sociology Occasional Paper No. 2134, Columbus: The Ohio State University.

Gonzalez-Vega, Claudio (1996), "A Note on Finance, Economic Growth, and Poverty Alleviation," unpublished, Columbus, Ohio: The Ohio State University.

Gonzalez-Vega, Claudio (1997a), "The Challenge of Transfering the New Lending Technologies to Reach the Poor from the Urban to the Rural Areas: Questions from Theory and Lessons from Microfinance Best Practice," paper presented at the Meetings of the International Association of Agricultural Economists, Sacramento, California, August.

Gonzalez-Vega, Claudio (1997b), "Do Financial Institutions Have a Role in Assisting the Poor?" in T. Wierand, J.D. Von Pischke, and Mwangi S. Kimenyi (eds.), *Strategic Issues in Microfinance*, Brookfield, VT: Avebury, forthcoming.

Greenwood, J. And B. Jovanovic (1990), "Financial Development, Growth, and the Distribution of Income," *Journal of Political Economy*, Vol. 98, No. 5, pp. 1076-1107.

Gurley, John G., and Edward S. Shaw (1967), "Financial Structure and Economic Development," *Economic Development and Cultural Change*, Vol. 15, No. 3, April, pp. 257-268.

Hoff, Karla and Joseph Stiglitz (1993), "Introduction" in Karla Hoff, Avishay Braverman, and Joseph Stiglitz (eds.), *The Economics of Rural Organization. Theory, Practice and Policy*, Oxford: Oxford University Press.

Hulme, David and Paul Mosley (1996), *Finance Against Poverty*, London: Routledge.

Kapur, Basant K. (1983), "Optimal Financial and Foreign-Exchange Liberalization of Less Developed Economies," *Quarterly Journal of Economics*, XCIII, February, p. 41-62.

King, Robert G., and Ross Levine (1993a), "Finance and Growth: Schumpeter Might Be Right," *The Quarterly Journal of Economics*, Vol. CVIII, No. 3, August, pp. 717-737.

King, Robert G., and Ross Levine (1993b), "Finance, Entrepreneurship, and Growth," *Journal of Monetary Economics*, Vol. 32, pp. 513-542.

Levine, Robert and S. Zervos (1996), "Stock Market Development and Long-Run Growth," *The World Bank Economic Review*, Vol. 10, pp. 323.329.

Lucas, Robert E. (1988), "On the Mechanics of Economic Development," *Journal of Monetary Economics*, Vol. 22, pp. 3-42.

Mathieson, Donald J. (1980), "Financial Reform and Stabilization Policy in a Developing Economy," *Journal of Development Economics*, Vol. 7, September.

McKinnon, Ronald I. (1973), *Money and Capital in Economic Development*, Washington, D.C.: The Brookings Institution.

McKinnon, Ronald I. (1988), *Financial Liberalization and Economic Development. A Reassessment of Interest-Rate Policies in Asia and Latin America*, San Francisco: International Center for Economic Growth.

Morduch, Jonathan (1997), "The Microfinance Schism," unpublished, Cambridge, MA: Harvard University.

Pagano, M. (1993), "Financial Markets and Growth: An Overview," *European Economic Review*, Vol. 37, pp. 613-622.

Rashid, Mansoora, and Robert M. Townsend (1992), "Targeting Credit and Insurance: Efficiency, Mechanism Design, and Program Evaluation," Unpublished report for The World Bank, December.

Rhyne, Elisabeth, and Maria Otero (1994), "Financial Services for Microenterprises: Principles and Institutions," in Maria Otero and Elisabeth Rhyne (eds.), *The New World of Microenterprise Finance. Building Healthy Financial Institutions for the Poor*, West Hartford: Kumarian Press.

Romer, Paul (1986), "Increasing Return and Long-Run Growth," *Journal of Pollical Economy*, Vol. 94, pp. 1002-1037.

Rosenzweig, Mark and Kenneth Wolpin, "Credit Market Constraints, Consumption Smoothing and the Accumulation of Durable Production Assets in Low-Income Countries: Investments in Bullocks in India," *Journal of Political Economy*, Vol. 101, No. 2, pp. 223-244.

Saint-Paul, G. (1992), "Technological Choice, Financial Markets, and Economic Development," *European Economic Review*, Vol. 36, pp. 738-781.

Schmidt, Reinhard H., and Claus-Peter Zeitinger (1994), "Critical Issues in Small and Microbusiness Finance," paper presented at the International Donor Conference on Financial Sector Development, Vienna.

Shaw, Edward S. (1973), *Financial Deepening in Economic Development*, New York: Oxford University Press.

Stiglitz, Joseph E. (1993), "The Role of the State in Financial Markets," Proceedings of the World Bank Annual Conference on Development Economics, supplement to *The World Bank Economic Review*.

Van Winjbergen, Sweder (1983), "Credit Policy, Inflation, and Growth in a Financially Repressed Economy," *Journal of Development Economics*, August-October.

Von Pischke, J.D. (1991), *Finance at the Frontier. Debt Capacity and the Role of Credit in the Private Economy*, Washington, D.C.: The World Bank.

Von Pischke, J.D. (1997), "The Financial Systems Approach to Development Finance and Reflections on its Implementation," paper presented at the First Annual Seminar on New Development Finance, Frankfurt, September.

Winkler, Adalbert (1992), "Financial Development, Economic Growth and Corporate Governance," paper presented at the First Annual Seminar on New Development Finance, Frankfurt, September.